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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

November /December 1989

SHOULD THE FED PURSUE ZERO INFLATION?

Federal Reserve Board (Fed) policy, since at least the beginning of 1988, has been designed to lower inflation and inflationary pressures by reducing economic growth. Despite the unambiguous evidence of the last thirty years, which shows that low inflation occurs when economic growth is high, the Fed has increased interest rates in the past year and a half by almost 300 basis points in order to stifle growth. Such a rise in interest rates has touched off a serious enough slowdown in the interest-rate-sensitive sectors that many analysts are now concerned about the possibility of a recession in the near future.

While such a prediction is unlikely to come true, the economic slowdown has already produced casualties. Employment growth in the last four months has been cut in half and unemployment has stopped falling. Annual interest payments on the federal debt in 1989 have risen by a greater percentage than the debt itself. A continuation of high interest rate policy could add 650,000 workers to the roles of the unemployed in 1990 and raise the federal debt by $345 billion in the next five years. High interest rates have already discouraged investment and led to a reduction in productivity.

Throughout 1989, evidence of the economic slowdown has been the strongest in the manufacture of durable goods, housing, construction and capital spending — sectors which, prior to this slowdown, had contributed very little to inflation. The decline in each of these interest-rate-sensitive sectors is a direct result of the Fed's high interest rate policy. How much and how fast interest rates actually fall over the next several months will determine the extent of the recovery in these sectors.

The slowdown in economic growth engineered by the Fed has been evident for more than just the past several months. Real GNP in the fourth quarter of 1987 was 5.4 percent above real GNP for the fourth quarter of 1986. Since then, economic growth has fallen steadily as interest rates rose. Real GNP growth stands at 2.9 percent in the third quarter of this year.

The pattern for overall real GNP growth is mirrored by a slowdown in the nonfarm business sector, which accounts for about 79 percent of GNP. Output growth in the nonfarm business sector has declined from 6.3 percent at the end of 1987 to 3.3 percent at present. Productivity growth has also fallen from over 3 percent during 1987 to just under 1 percent in the nonfarm business sector today. As a result of the slowdown in output growth and productivity, unit labor costs are currently increasing at a 4.4 percent annual rate, whereas during 1987, unit labor costs grew only about 1 percent.

The Fed finds itself in an awkward situation. Inflation is coming down nicely due to restrained money supply growth since the beginning of 1987. However, Fed rhetoric for most of the last 18 months has warned of an impending acceleration of inflation from a variety of sources, most of which were associated with rising economic growth and have since ceased to be signalling the alleged inflationary pressures. With inflation and inflationary pressures falling, the Fed finds it difficult to, in effect, shift gears away from dire warnings about the consequences of too much economic growth.

But a policy shift is being called for from a variety of sources both within and outside the Fed. The declining inflation rate, the overwhelming evidence of an economic slowdown and a high cost of capital in the U.S. relative to other nations leads many observers to suggest that interest rates should fall. However, the Fed finds it difficult to rationalize reduced interest rates in a timely fashion. For if the Fed were to do so, such an action would appear to run counter to its almost two-year-long battle to reduce inflation.

The Fed's dilemma has been compounded by calls for the Fed to reduce inflation from the present rate of

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Dr. Richard W. Rahn, Vice President and Chief Economist
Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1989-1990
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS		
	Actual		Forecast					Actual	Forecast	
	89/2	89/3	89/4	90/1	90/2	90/3	90/4	1988	1989	1990
GROSS NATIONAL PRODUCT										
Real GNP	2.5	2.5	2.3	2.9	3.4	2.9	3.0	4.4	3.0	2.8
Consumption	1.9	5.8	2.0	2.4	3.0	2.7	2.6	3.4	2.8	2.6
Residential Investment	-12.3	-4.8	2.4	5.1	3.6	6.0	1.8	-0.4	-2.1	2.0
Nonresidential Investment	8.6	5.3	4.8	3.8	4.4	7.2	8.7	8.4	3.8	5.1
Equipment	14.8	5.2	4.6	5.1	4.3	8.4	10.6	11.5	6.0	6.4
Structures	-9.5	5.9	0.7	-0.7	4.8	3.0	2.0	-0.1	-2.7	0.5
Exports	13.1	0.0	6.6	8.3	6.7	5.8	5.6	17.6	9.9	7.0
Real Net Exports (82$B)	-51.2	-74.1	-66.0	-60.0	-56.1	-50.4	-46.1	-74.9	-64.7	-52.9
Imports	9.3	15.1	3.9	5.1	4.0	3.9	4.2	6.8	6.6	4.9
Government Purchases	5.4	-2.3	-0.5	1.5	0.6	-0.9	0.6	0.4	2.8	0.5
Final Sales	3.1	1.4	2.1	2.9	3.2	2.8	3.0	4.3	2.9	2.6
Change in Business Inventories (82$B)	19.1	30.2	15.1	22.3	24.9	25.7	25.8	27.9	21.5	24.7
Industrial Production	2.0	1.3	2.1	2.3	4.6	5.1	4.5	5.7	3.4	3.1
New Car Sales (mill.)	10.3	10.8	10.5	10.7	10.9	11.0	11.0	10.6	10.3	10.9
Domestic Car Sales (mill.)	7.3	7.9	7.5	7.7	7.9	8.0	8.1	7.5	7.3	7.9
New Housing Starts (mill.)	1.36	1.34	1.40	1.50	1.56	1.64	1.66	1.49	1.39	1.57
EMPLOYMENT, WAGES AND PRICES										
Civilian Unemployment Rate (%)	5.3	5.3	5.4	5.5	5.5	5.4	5.3	5.5	5.3	5.4
Compensation	6.8	4.8	4.8	4.6	4.4	4.3	4.2	4.9	5.6	4.8
Productivity	1.6	1.2	0.7	1.8	2.2	2.1	1.9	1.8	1.1	1.6
Unit Labor Costs	5.1	3.5	4.1	2.8	2.2	2.2	2.3	3.1	4.5	3.2
Consumer Price Index	5.7	1.6	3.5	3.4	3.3	3.1	3.0	4.1	4.7	3.5
Implicit GNP Deflator	4.6	2.9	3.6	3.4	3.1	3.0	2.9	3.3	4.0	3.3
Prime Interest Rate (%)	11.3	10.7	9.8	9.3	8.9	8.5	8.3	9.3	10.7	8.8
3-mos. Treasury Bill Rate (%)	8.4	7.8	7.3	6.9	6.6	6.4	6.2	6.7	8.0	6.5
Corporate Bond Rate (%)	9.5	9.0	8.6	8.4	8.2	8.0	7.9	9.7	9.2	8.1
Real Personal Disposable Income	0.8	4.8	1.2	1.9	2.3	4.7	5.0	4.4	3.7	3.4
Changes in Profits from Current Production ($B)1	-8.5	-2.0*	1.8	3.6	9.1	7.0	6.1	29.9	-18.6	13.0

* Projected change from second quarter of 1989.

[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains advance estimates of the National Income and Product Accounts for the third quarter of 1989. The nation's money supply M(2) is assumed to grow by 4.0 percent in 1989 and 4.3 percent in 1990. The trade weighted exchange value of the dollar rises by 4.0 percent in 1989 and 2.0 percent in 1990.

about 4.3 percent down to lower rates. If the Fed were to attempt such a feat using its present policy approach, many analysts believe that inflation reduction might involve enormous costs and further casualties. There is a general belief that the Fed has such a difficult enough job at present — steering the economy between recession and an outbreak of new inflation — that an actual reduction in inflation below current levels just isn't feasible. Fed Chairman, Alan Greenspan, however, has indicated that while lowering inflation would involve some costs, the eventual benefits in the form of higher output, greater employment and lower interest rates would be worth it.

The debate over how low to take inflation and how quickly to get there has been made more noteworthy by actions in the House of Representatives. Representative Stephen Neal (D-N.C.) has introduced House Joint Resolution 409 directing the Federal Open Market Committee (FOMC) of the Fed to adopt and pursue monetary policies leading to, and then maintaining, zero inflation. H.J. Res. 409 stipulates that "inflation will be deemed to be eliminated when the expected rate of change of the general price level ceases to be a factor in individual and business decision-making." Just how low a rate of inflation is implied by such a statement, however, is unclear.

On Wednesday, October 25, 1989, Chairman Greenspan testified in support of the Neal resolution and against portions of another House bill, H.R. 2795, that seeks to make the Fed more accountable for its policymaking activities. H.R. 2795 would open the Fed to new audits of its monetary policy actions and require the Fed to reveal its near-term policy decisions at the time those decisions are made.

At present, there is very little congressional support for either House bill because of the general impression that Fed policymaking works well and an "if it ain't broke, don't fix it" attitude which is prevalent at this time. Many analysts think that the economy is now gliding in for a soft-landing — a situation where inflation is falling while economic growth is still positive at about a 2 percent annual rate. These analysts argue that such a low growth rate would not allow much room to further reduce inflation by further reductions to economic growth.

Both House bills attempt to address two serious shortcomings of existing Fed legislation. The Neal bill would alter legislated Fed policy goals to put price stability as the central, if not sole, goal of monetary policy. The Humphrey-Hawkins Act of 1978 charges the Fed to pursue several objectives simultaneously, including maximum economic growth, price stability, exchange rate stability and full employment.

The way Mr. Neal and Mr. Greenspan see it, however, price stability is a prerequisite to obtaining maximum economic growth, the lowest possible interest rates, full employment, the highest rates of saving and investment and exchange rate stability. Thus, the Neal bill would put the proper emphasis on the goals of monetary policy by setting price stability first thereby altering the existing Congressional understanding of the intent of the Humphrey-Hawkins legislation.

Putting price stability and the control of inflation first is essential. Inflation represents a reduction in the purchasing power of money and is a monetary phenomenon. The Fed, through its creation of reserves, creates inflation in the first place. And since it has but just one policy instrument, the control of reserves, it makes sense to have only one policy objective — maintaining the purchasing power of money through price stability or zero inflation.

Portions of the other House bill, H.R. 2795, address another fundamental concern over Fed policy. Currently, near-term Fed policy is cloaked in secrecy. Credit market participants can only guess at the intent and direction of Fed policy. Since the Fed may be pursuing several goals at once, market participants rarely know toward which end and for how long any given policy will remain in force.

Speaking against those portions of H.R. 2795 that would let everyone know what the Fed is up to, Mr. Greenspan claimed that the Fed needs policy flexibility for a period of time to do what it believes must be done. The gist of his remarks seemed to suggest that if Fed policy intentions were known at the time the decisions were made, there might be considerable unpopular sentiment generated about the Fed's decisions. Moreover, the impact of any given movement in Fed policy, if such a correction was known at the time, would be minimal. This is a polite way of saying that the Fed wishes to be able to surprise markets in order to manipulate market behavior over the short-run.

The debate over Fed secrecy has yet to be engaged in any great detail. But the Fed Chairman's remarks reveal that the Fed, if it were to pursue price stability or zero inflation, would desire the full breadth of near-term policy flexibility that it has become used to. In short, the Fed does not see any way to reduce inflation without cooling off the economy as well, and it cannot publicly rectify its long-term desires for price stability with its near-term policy posture.

In listening to Mr. Greenspan's testimony, it is clear that there is an uncomfortable conflict between near-term and long-term policymaking goals at the Fed. Apparently, everyone can agree that a long-term goal of price stability or zero inflation is laudable. But agreement is hard to reach on what to do to get there. In the finest tradition of Fed watchers everywhere, let us suggest how to remove this conflict.

The Fed must reduce uncertainty and maintain a stable, predictable monetary policy. Based upon our interpretation of Fed actions, it is reasonable to conclude that members of the Fed adjust policy frequently. They seem to rely on such monthly indicators as how fast vendors make deliveries and employment head counts, to name a few, to gauge the

strength of the economy and, hence, nascent inflationary pressures.

However, credit market participants are unaware of subtle shifts in Fed policy, and do not understand the relationship of the actions of the Fed's Open Market Desk to the carrying out of Fed monetary policy. Consequently, a great deal of uncertainty exists in credit markets about near-term Fed actions, and this uncertainty is reflected in interest rates.

Thus, interest rates, in addition to compensating lenders for the use of funds — including additional premiums for unforeseeable business risk and inflation expectations — also contain a risk premium due to meandering Fed policy. As such, interest rates, especially short-term rates, are higher than they otherwise would be. If Fed policy were well understood and enumerated and effectively ruled out as a source of instability in near-term credit market activity, the Fed premium could be eliminated.

How large the Fed premium has become is difficult to estimate, but it could be as high as 200 basis points or 2 percentage points on the shortest-term rates. What this added premium represents is an extra return lenders or investors require to compensate for adverse changes in interest rates during the time it takes before the Fed reveals its latest near-term policy intentions — which is generally a year too late for market participants and virtually useless since, by the time the Fed reveals what it has done, Fed policy has likely changed course. The upshot of a Fed premium is to discourage lending and investing at lower, but, based upon risk and inflation premiums alone, clearly feasible interest rates.

Thus, today's interest rates could fall to much lower levels if the Fed were to announce and follow clearly stated near-term policy goals. Such a near-term policy should be consistent with long-term efforts to reduce inflation. For example, the Fed could announce its intention to reduce inflation over the next five years by holding money aggregate growth somewhat below the current rate of growth in nominal GNP. Accompanying such an announcement, the Fed would make clear that it would deviate from this course only if an emergency developed, such as a sudden slip in stock market prices, to provide emergency liquidity to the banking system.

The Fed's job would not necessarily be easy. Maintaining money aggregate growth close to its target would require continual efforts to adjust reserves. But these actions would be well understood and market participants would construe even unexpected reserve changes as being part of a plan to reduce inflation, not as an attempt to limit economic growth or maneuver exchange rates. *Thus, near-term and long-term monetary policy would become consonant, and the benefits of price stability may be enjoyed prior to actually obtaining such stability because businesses could plan for low future inflation.*

The Fed's toughest job would be to change its image by countering its own past rhetoric. In trying to reduce inflation by curtailing economic growth, the Fed has transformed good news on the economic front into bad news on the policy front. The October employment report was above predictions, indicating that the slowdown was not as pronounced as some analysts thought. Yet, instead of basking in the sunlight of good growth news, the market reaction was to become alarmed that the Fed would be reticent to allow interest rates to fall as many expect should happen.

The upshot of an open Fed policy which removed the Fed premium from interest rates and convinced businesses and credit market participants that inflation would likely fall would be just what the Fed is seeking, but cannot obtain by present policy — falling interest rates while maintaining a tight, inflation-reducing monetary policy. Such a move by the Fed to more openness does not require legislation. It requires only the courage to put forth consistent monetary policy plans that the American public can believe and count on.

RECENT ECONOMIC POLICY DIVISION PAPERS

Dr. Orawin Velz, "Concerned About Saving? Why Not Stop Taxing It!," *Policy Working Papers.*

Dr. Lawrence A. Hunter, Dr. Donald R. Leavens, and Dr. Orawin Velz, "Still Broken After All These Years," Discussion Paper on Social Security.

Dr. William K. MacReynolds, "G-7 Blues And The Outlook For The Dollar," *Economic Snapshot.*

Dr. William K. MacReynolds, "Inflation Scares: Still Fighting The Last War," *Economic Snapshot.*

Testimony on Capital Gains Taxation, by Dr. Richard W. Rahn, given before the House Committee on Small Business.

Dr. Donald R. Leavens, "High Economic Growth Does Not Produce Inflation," *Economic Fact Sheet.*

Dr. Donald R. Leavens, "Federal Reserve's Plan To Restrain Economic Growth Will Increase National Debt An Additional $345 Billion By 1994," *Economic Fact Sheet.*

Dr. Donald R. Leavens, "Federal Reserve's Plan To Restrain Economic Growth Will Add 650,000 To Unemployment Roles," *Economic Fact Sheet.*

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

January/February 1990

WILL INTEREST RATES FALL AGAIN?

On January 9, 1990 several banks lowered their prime lending rate from 10.5 percent to 10 percent. This was the first time the prime rate had fallen since the end of July, when it dropped 1/2 point. Analysts had been expecting the prime rate to drop well before it finally did. From the beginning of October to the end of December 1989, the Federal Funds Rate fell 75 basis points as a result of Federal Reserve (Fed) actions that substantially increased bank reserves. (The Federal Funds Rate is the rate banks charge each other for overnight loans and the rate that is most directly controlled by the Federal Reserve.) Yet the prime rate stubbornly refused to decline.

Since August, even though the Fed has allowed bank reserves to grow at an annual rate of near 9 percent and has substantially increased the amount of excess reserves available for lending, interest rates other than the Federal Funds Rate did not fall. It appears that it is easier for the Fed to raise interest rates as it set out to do in March 1988 than it is to lower them as it has tried since last June.

The slight movement in interest rates between September and January while Fed credit policy was highly expansive, indicates that the Fed is incapable of fine-tuning the economy. The Fed must resort to "gross-tuning," alternately slamming on the brakes and revving up the economy to get the results it seeks. Since June, money aggregate growth, especially M1 and M2, has surged, reversing its path of slow and negative growth during the first half of 1989. Over the last six months of 1989, M1 grew at 6 percent and M2 at over 8 percent.

Surging money supply growth tends to add to inflation expectations and raises concerns about the Fed's assessment of economic health. Thus, the shift in Fed policy of easing credit conditions may explain why both long-term and short-term interest rates have been so slow to decline even though the Federal Funds Rate has dropped.

Longer-term lenders and borrowers tend to form expectations about inflation which are built into market interest rates. These expectations likely changed very little even during the long period of high and rising interest rates. While economic growth has fallen from over 5 percent in late 1987 to 3 percent today, core inflation has fluctuated in a small range.

Core inflation — Consumer Price Index (CPI) inflation less volatile food and energy prices — rose in early 1987 after two years of excessive money supply growth. Since the end of 1987, it has fluctuated between 4.2 and 4.5 percent. However, M2 money supply growth, which in the long-term determines inflation, has fluctuated considerably — between annual growth rates of 1 to 8.5 percent. With the recent surge in money supply growth, it is unlikely that inflation expectations have benefited from recent evidence of a slight decline in core inflation. What longer-term credit market participants need is some reassurance that money supply growth will be contained sufficiently to meet the Fed target of 5 percent growth in M2.

Consequently, lenders are less willing to make loans when the inflation picture is in such doubt and when they are unsure that the economic expansion will continue to a sufficient degree to maintain credit quality. After the long rise in interest rates, some industries such as manufacturing and housing have gone into a tailspin. This tends to focus lending activity on higher quality debt instruments until the path of the economy is clearer. Thus lenders require somewhat higher interest rates in short-term and long-term markets to compensate for the risk associated with a greater near-term probability of an overall economic downturn.

This credit market uneasiness is a direct result of unpredictable Fed intervention to manipulate interest rates. By following a credit policy instead of a monetary policy, the Fed has increased the risk of

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	QUARTERS							YEARS		
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	89/2	89/3	89/4	90/1	90/2	90/3	90/4	1988	1989	1990
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Real GNP	2.5	3.0	1.9	2.9	3.4	2.9	3.0	4.4	3.0	2.8
Consumption	1.9	5.6	-0.8	2.7	3.1	2.6	2.6	3.4	2.7	2.4
Residential Investment	-12.3	-9.2	0.0	5.2	3.6	6.2	1.9	-0.4	-2.8	0.8
Nonresidential Investment	8.6	5.2	6.2	3.7	4.4	7.2	8.4	8.4	4.1	5.6
Equipment	14.8	4.6	7.4	5.0	4.3	8.4	10.2	11.5	6.0	6.7
Structures	-9.5	8.0	2.1	-0.7	4.6	3.0	2.0	-0.1	-1.7	2.0
Exports	13.1	3.9	7.9	8.2	6.5	5.8	5.6	17.6	11.1	7.2
Real Net Exports (82$B)	-51.2	-57.1	-49.6	-47.9	-44.5	-43.4	-42.5	-74.9	-53.2	-44.6
Imports	9.3	7.4	2.6	6.6	4.0	4.8	4.8	6.8	6.1	5.3
Government Purchases	5.4	-2.4	2.8	1.5	0.5	-0.9	0.6	0.4	2.8	1.2
Final Sales	3.1	2.7	1.8	2.9	3.2	2.8	3.0	4.3	3.2	2.7
Change in Business Inventories (82$B)	19.1	21.9	23.1	23.1	25.7	26.5	26.6	27.9	22.1	25.3
Industrial Production	2.0	1.3	2.1	2.3	4.6	5.1	4.5	5.7	3.4	3.1
New Car Sales (mill.)	10.3	10.8	10.0	10.7	10.9	11.0	11.0	10.6	10.1	10.9
Domestic Car Sales (mill.)	7.3	7.9	7.0	7.7	7.9	8.0	8.1	7.5	7.1	7.9
New Housing Starts (mill.)	1.36	1.34	1.40	1.50	1.56	1.53	1.53	1.49	1.39	1.53
EMPLOYMENT, WAGES AND PRICES										
Civilian Unemployment Rate (%)	5.3	5.3	5.4	5.5	5.5	5.4	5.3	5.5	5.3	5.4
Compensation	6.8	4.7	4.8	4.6	4.4	4.3	4.2	4.9	5.6	4.8
Productivity	1.6	1.7	1.6	1.8	2.2	2.1	1.9	1.8	1.5	1.8
Unit Labor Costs	5.1	3.0	3.2	2.8	2.2	2.2	2.3	3.1	4.1	3.0
Consumer Price Index	5.7	1.6	3.5	3.4	3.3	3.1	3.0	4.1	4.6	3.5
Implicit GNP Deflator	4.6	3.2	3.6	3.4	3.1	3.0	2.9	3.3	4.1	3.3
Prime Interest Rate (%)	11.3	10.7	10.4	9.8	9.3	9.0	8.7	9.3	10.8	9.2
3-mos. Treasury Bill Rate (%)	8.4	7.8	7.6	7.1	6.6	6.4	6.2	6.7	8.1	6.6
Corporate Bond Rate (%)	9.5	9.0	8.6	8.4	8.2	8.0	7.9	9.7	9.2	8.1
Real Personal Disposable Income	0.8	4.4	1.2	1.9	2.3	4.7	5.0	4.4	4.0	2.6
Changes in Profits from Current Production ($B)[1]	-8.5	-12.6	-1.5	8.9	9.1	7.0	6.1	29.9	-25.3	12.2

[1] Corporate profits with inventory valuation and capital consumption allowances.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains final estimates of the National Income and Product Accounts for the third quarter of 1989. The nation's money supply M(2) is assumed to grow by 4.0 percent in 1989 and 4.3 percent in 1990. The trade weighted exchange value of the dollar rises by 2.0 percent in 1990.

short-term variability in interest rates to such a degree that interest rates are not falling even though credit conditions have eased considerably.

Many analysts treat the interest rate as the cost of money. It is not. Interest rates reflect the cost of credit for the various borrowers in credit markets. True monetary policy attempts to match the supply of money to the demand for holding money to make transactions with or to satisfy liquidity desires. If the Fed supplies too much money, people try to convert their money holdings into other assets or goods by increasing spending. As the result of people disposing of their money, the price level rises until they are induced to hold onto just the amount of money the Fed supplied. The price of money is its purchasing power which declines when there is too much money compared to its demand.

When the Fed manipulates reserves with an eye toward targeting interest rates, it permits wide fluctuations in money aggregate growth. Consequently, interest rates may move very little while money aggregates and expenditure patterns change dramatically. Indeed, rising interest rates will lower the demand for money because it makes holding other financial assets more attractive. Thus high interest rates may lead to more spending and more inflation if the high rates result in a substantial fall in the demand for money.

Most of the time it is not clear what Fed policy is trying to achieve. Since June, it appears that the Fed has been trying to avert a recession with easy credit. But credit markets have from time to time misinterpreted what, in retrospect, appears to have been easier credit policy. The problem is that no one can predict when and to what degree Fed interest rate policy will change.

Fed policy is based upon a variety of contingencies and is enacted secretly without any clear understanding by the public of what the Fed is doing until many months afterward. As a result, there is an additional premium on short-term interest rates, the Fed premium, which prevents interest rates from falling even though the amount of excess reserves for lending is high.

The combination of the Fed premium and uncertain inflation expectations will keep interest rates from falling as fast as they otherwise would. Consequently, the economy will experience below trend economic growth even though money supply growth is presently surging. What the Fed must guard against and avoid in the future, is a continuation of highly variable money supply growth. As we have argued previously, slow economic growth does not reduce inflation. Quite the contrary. Higher rates of economic growth are associated with low rates of inflation, and the aim of monetary policy in both the near-term and the long-term should be to maintain economic growth at sufficiently high rates to avoid continued declines in the purchasing power of money.

There is a close long-term relationship between money supply growth in M2 and nominal (current dollar) GNP growth. Beginning in 1987, the Fed was able to reduce M2 growth to 5.5 percent from 9.0 percent in the two previous years. And although M2 growth has fluctuated in a wide range since then, it has averaged 5 percent growth since the end of 1987. Reduced M2 growth has served to lower nominal GNP growth from over 8 percent to where is stands today at 6.2 percent.

In the four years from 1984 through 1987, inflation was 39 percent of nominal GNP growth and real GNP growth stood at 61 percent of nominal GNP growth. Yet because the Fed has focused on curtailing economic growth with high interest rates, real GNP growth is now just a little less than 40 percent of nominal GNP growth and inflation makes up almost 60 percent of current dollar GNP growth. High interest rates have worked to lower real economic growth, but have not reduced the threat of inflation.

If Fed policy was designed to lower inflation, it has failed. Only real GNP growth has come down sending threatening signals about the current strength of the economic expansion. The economy is at a crossroad where the predictions of falling economic growth are more prevalent than predictions of a pick-up in economic activity. By following a high interest rate policy, the Fed has placed the survival of the longest peacetime economic expansion in jeopardy without any perceptible improvement in the outlook for inflation.

What is certain to happen in the near-term is that nominal GNP growth will continue to decline. If the Fed would focus on maintaining monthly growth rates in M2 and other monetary aggregates at just below nominal GNP growth — a real monetary policy — the Fed premium would disappear and credit markets would send interest rates lower. This would induce greater real economic growth and a lower inflation rate than the consensus of private economic forecasters anticipates. Such a policy requires the Fed to abandon interest rate manipulation. This change would promote stability in credit markets because participants would be confident of the intent and direction of Fed policy. Our forecast for 1990 is based upon a change in Fed policy to focus more upon monetary aggregate growth, which as Fed research indicates, is the primary determinant of inflation.

When the Department of Commerce reports on fourth quarter 1989 Gross National Product (GNP) in late January, the economy will record its slowest quarter of growth since 1986. But beginning with the first quarter of 1990, the economy will pick up again. Real GNP growth in 1990 will stay near 3 percent, below the 4 percent trend rate experienced during the record peacetime expansion.

As a result of two straight years (1989 and 1990) of below potential growth, the unemployment rate should rise slightly to 5.4 percent. This will be the first

yearly rise in the unemployment rate during the historic expansion. The rise in the unemployment rate will occur as a lagged result of the current economic slowdown.

A major change in inflation should occur in 1990. Core inflation has risen between 3.7 percent and 4.3 percent since 1984. It last rose above 4 percent in late 1987 as a result of substantial increases in money supply growth in 1985 and 1986. Core inflation has changed very little since late 1987 remaining above 4 percent through the end of 1989. But since the beginning of 1987, money supply growth has been held to a yearly average of about 5.5 percent. Consequently, inflation should average 3.5 percent in 1990 reaching 3.0 percent in the last quarter of the year.

Falling inflation will bring interest rates down considerably in 1990. Short-term rates, such as the three-month Treasury bill, will fall about 150 basis points reaching 6.2 percent by the end of 1990. Long-term rates will fall as well as inflation expectations recede. The corporate bond rate will hit 7.9 percent by the end of 1990 while the 30-year Treasury bond rate will drop to 7.0 percent.

Personal income will continue to rise at about the same rate as nominal GNP, at 6.0 percent. The combined tax and inflation take out of personal income will leave growth in real disposable income of 2.6 percent. Consequently, real consumer spending will rise at a modest 2.4 percent while the personal saving will average about 5.5 percent of disposable income.

The slowdown in consumption in 1989 will keep business investment from rising in 1990. But lower interest rates will induce an overall modest rebound in real fixed nonresidential investment up to 5.6 percent growth in 1990. Declining interest rates will also spur a mild comeback in housing and automobiles.

Real net exports should rise once again as exports reach an all-time high out-pacing import growth by 7.2 percent to 5.3 percent. Hence, the trade deficit will fall to just about one percent of GNP.

Our forecast stands above the consensus of private forecasters for economic growth and below the consensus for inflation. If the economy performs as well as we predict, many analysts will credit the Fed with averting a potentially serious inflation crisis in 1989 and 1990 because of its high interest rate policy. They will be wrong. Fed high interest rate policy gave the economy less growth and more inflation in 1988 and 1989 than otherwise would have been the case. And growth in 1990 will be below potential because of the lingering effects of the Fed's high interest rate policy.

The Fed is trying to contain inflation. Its policy choice has been to keep short-term rates high so that long-term and short-term rates can then fall. This perverse scheme is fraught with difficulties. The Fed cannot credibly lower interest rates without appearing to go back on its well-enumerated, anti-inflation policy stance. The Fed has cut economic growth, but has not achieved a reduction in inflation that is in any way commensurate with its impact on economic growth.

Our concern over Fed policy is primarily over the choice of an inappropriate "intermediate" target — manipulation of economic growth. Neither the Fed nor anybody else knows where growth potential of the economy lies. The Fed wants to keep the economy below an assumed 2.5 percent growth potential because it argues we can best control inflation when we are somewhat removed from the vicinity of full employment. Unfortunately, no one knows where full employment is.

With such a strong relationship between money supply growth and inflation over the long-term, it would make more sense to let GNP growth find its own sustainable rate in a restrained money supply growth environment. Then the Fed would have a credible and convincing monetary policy and price stability at lower rates of inflation would be an obtainable goal. Thus, interest rates could fall even though monetary policy would be considered tight.

RECENT ECONOMIC POLICY DIVISION PAPERS

Dr. William K. MacReynolds, "The Trust Fund Game," *Economic Snapshot.*

Dr. William K. MacReynolds, "The Prosperity Dividend," *Economic Snapshot.*

Dr. Lawrence A. Hunter, "Yes, Mr. President, There is a Peace Dividend."

Dr. Lawrence A. Hunter, "Read My Lips: You Just Got New Taxes."

Dr. Donald R. Leavens, "How Much Are You Overpaying for Social Security?"

Dr. Lawrence A. Hunter, Dr. Donald R. Leavens, and Dr. Orawin Velz, "Still Broken After All These Years," Discussion Paper on Social Security.

A38YC-6 A

ECONOMIC OUTLOOK

Chamber of Commerce of the United States

March/April 1990

IS THE LONG EXPANSION OVER?

The Government's index of leading indicators fell five times and rose six times between January 1989 and December 1989. January 1990's index was unchanged. Thus, many analysts conclude that stagnation and sluggishness are likely in the near-term outlook for the economy. In February, the consensus of Blue Chip private forecasters registered a projected growth rate of 1.6 percent for 1990. If their projections were to come true, 1990 would be the slowest year for the economy since its expansion began in 1983.

The consensus, however, is an average of widely disparate opinions about where the economy is headed over the next year. Although analysts often have different opinions, today's extremes lie farther away than usual from the midpoint. Taken alone, both extremes can be supported by arguments just as convincing as the median guess on the economy. For example, the National Bureau of Economic Research, representing one extreme, publishes a credible but experimental leading index for the economy that currently indicates a strong upward surge in real economic growth by the beginning of summer.

At the other extreme are several analysts who believe that the economy is already in a recession. One consumer survey indicates that almost 80 percent of households think they are experiencing what can be interpreted as a recession. Other analysts think that sluggish growth will get worse. They point to high interest rates in foreign countries, rising interest rates in the U.S. and a dollar that is, in their opinion, over-valued to suggest that foreign demand for U.S. exports will fall. Falling exports would bring to an end the most powerful engine of growth the U.S. economy has experienced in the past two years. Clearly, both of the extremes can't be right.

Among the positive signs for the economy in 1990 is the 4 percent growth in real disposable income experienced over the past two years. Thus, households enter 1990 with considerable purchasing power and consumer spending should be strong enough to lead to rising real GNP growth as 1990 proceeds.

The economic slowdown experienced in 1989 has not produced traditional concerns of a recession as the result of excessive inventory build-up. Inventories as a portion of sales and shipments are fairly low compared to levels experienced throughout the long economic expansion. Consequently, a slight rebound in consumption will gradually increase industrial production since there are no significant excessive inventories that need to be used.

Productivity gains will be modest in 1990 as businesses attempt to cut costs. These gains will eventually reverse the decline in profits. Near the end of 1990, the prospects for the economy and profit-making will turn strongly positive and investment will pick up again leading economic growth upward in 1991.

The drop in productivity and the resulting rise in unit labor costs and fall in profits in 1989 was a direct result of Fed actions to slow economic growth with high interest rates. In early 1988, when the Fed sought to reduce inflation and inflationary pressures by slowing growth, the economy was expanding near 5 percent. Growth now stands at just about 2 percent. Unfortunately, Fed actions, contrary to their intent, have failed to reduce inflation, and interest rates have stayed high while growth has tumbled. The Chamber has consistently opposed high interest rate policy, precisely because it prolongs inflation by raising business costs and destabilizing the economy.

Not only was the Fed's policy dangerous, it was unnecessary. Upward pressures on inflation from increased aggregate demand would have receded sometime in 1988, because the Fed reduced M2 money supply growth below the growth in aggregate demand beginning in early 1987. Restrained M2 growth serves to reduce the growth in aggregate demand — nominal GNP — which fell from over 8 percent in 1988 to about 7 percent in 1989. As the graph indicates, there is a strong relationship between M2 money supply growth

Economic Outlook, published bimonthly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year which includes *Policy Working Papers*. Individual copies of the *Outlook* can be purchased for $7.50 per copy.

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Dr. Richard W. Rahn, Vice President and Chief Economist
Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1990-1991
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS									YEARS		
	Actual	Forecast								Actual	Forecast	
	89:4	90:1	90:2	90:3	90:4	91:1	91:2	91:3	91:4	1989	1990	1991
GROSS NATIONAL PRODUCT												
Real GNP	0.9	2.0	2.9	3.3	3.5	3.1	3.4	3.5	3.6	3.0	2.4	3.3
Consumption	0.4	2.1	3.2	3.2	3.0	2.7	2.9	3.0	3.1	2.7	2.6	3.0
Residential Investment	-0.6	1.9	4.1	5.3	3.4	0.6	3.1	0.8	3.5	-2.8	-0.1	2.6
Nonresidential Investment	-6.4	-1.7	-0.9	2.0	5.2	7.8	8.7	7.3	7.3	3.3	-0.1	6.1
Equipment	-8.4	-2.6	-1.3	2.2	5.1	10.0	8.6	9.2	8.4	4.9	-0.5	7.1
Structures	0.0	3.0	1.0	1.6	1.0	0.6	9.1	1.3	3.5	-1.8	1.5	2.8
Exports	8.6	7.8	8.4	6.6	7.4	6.6	6.6	5.9	5.8	11.1	7.8	6.9
Real Net Exports (82$B)	-48.2	-40.4	-33.6	-30.1	-25.5	-22.7	-20.1	-17.3	-15.6	-52.9	-32.4	-18.9
Imports	2.0	2.5	3.7	4.2	4.3	4.7	4.9	4.1	4.7	6.1	4.0	4.5
Government Purchases	1.3	2.0	-0.8	1.2	0.8	0.7	0.9	1.4	1.0	2.6	0.8	0.8
Final Sales	-0.5	2.4	2.7	3.1	3.2	3.1	3.5	3.4	3.4	3.0	2.3	3.3
Change in Business Inventories (82$B)	26.2	22.3	25.1	26.9	28.2	27.6	26.9	27.8	30.0	24.5	25.6	28.1
Industrial Production	0.2	-0.5	2.3	3.9	5.0	3.1	4.2	3.0	3.2	1.7	0.9	4.0
New Car Sales (mill.)	8.7	9.3	9.5	9.7	9.9	10.0	10.0	9.9	10.1	9.9	9.6	10.0
Domestic Car Sales (mill.)	6.2	6.7	6.8	6.9	7.0	7.1	7.1	7.1	7.2	7.1	6.8	7.1
New Housing Starts (mill.)	1.34	1.45	1.38	1.41	1.40	1.38	1.44	1.42	1.46	1.39	1.41	1.43
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.3	5.4	5.5	5.5	5.4	5.3	5.1	5.0	4.9	5.3	5.4	5.1
Compensation	6.9	5.7	5.1	4.5	4.9	5.4	4.7	4.5	4.4	5.5	5.7	4.9
Productivity	0.2	1.2	1.9	2.2	2.1	1.6	2.5	1.9	1.7	0.9	1.4	2.2
Unit Labor Costs	6.7	4.5	3.2	2.3	2.8	3.8	2.2	2.6	2.7	4.6	4.3	2.7
Consumer Price Index	5.2	5.1	4.0	3.7	3.5	3.4	3.3	3.3	3.2	4.6	4.0	3.5
Implicit GNP Deflator	3.2	3.4	3.1	3.0	2.9	2.8	2.6	2.5	2.3	4.1	3.3	2.8
Prime Interest Rate (%)	10.5	10.0	9.7	9.4	9.0	8.7	8.4	8.1	7.9	10.9	9.5	8.3
3-mos. Treasury Bill Rate (%)	7.6	7.8	7.3	7.1	6.8	6.6	6.4	6.2	6.0	8.1	7.2	6.3
Corporate Bond Rate (%)	8.9	9.1	8.8	8.6	8.4	8.3	8.1	7.9	7.7	9.3	8.7	8.0
Real Personal Disposable Income	2.6	0.9	2.4	4.2	4.7	3.1	2.9	2.0	3.4	4.1	2.6	3.7
Changes in Profits from Current Production ($B)[1]	-1.5*	4.7	7.9	9.6	6.1	4.7	2.1	3.3	4.7	-25.3	17.0	20.4

* Projected change from third quarter 1989.

[1] Corporate profits with inventory valuation and capital consumption allowances.

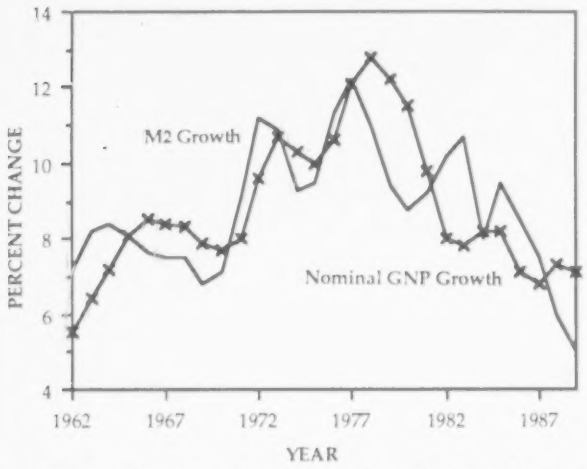
SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the fourth quarter of 1989. The nation's money supply M(2) is assumed to grow by 4.7 percent in 1990 and 4.4 percent in 1991. The trade weighted exchange value of the dollar rises by 2.0 percent in 1990 and 4.4 percent in 1991.

and growth in nominal GNP. Changes in M2 growth lead to changes in the same direction in nominal GNP growth after about a one-year lag.

M2 AND NOMINAL GNP GROWTH, 1962-1989



The strength of this fairly stable relationship leads analysts to predict nominal GNP growth in 1990 of 6 percent, plus or minus one percentage point. This is a much narrower band of variation than the wide band of disagreement in the forecasts for real GNP growth.

Two factors make up nominal GNP growth: they are real GNP growth and inflation. To reduce inflation, all the Fed had to do was to maintain money supply growth below the nominal GNP growth established in 1987. By implementing this policy, the Fed would have avoided hiking interest rates and impairing real GNP growth. Unfortunately, as a result of high interest rate policy, all of the decline in nominal GNP growth in 1989 came out of real GNP growth while inflation remained virtually unchanged. The consensus view is for more of the same in 1990.

However, research at the Fed suggests that at current rates of economic growth — which lie at the Fed's estimate of real growth potential — inflation should come down in 1990 as a result of low money supply growth which has averaged 5 percent for the past three years. Researchers have established a fairly reliable relationship between money supply growth and inflation. With a lag of about two years, inflation changes in the same direction as money growth.

More precisely, prolonged money supply growth of 5 percent should eventually create an equivalent 5 percent growth in aggregate demand. Thus, if real growth potential lies at 2.5 percent, a continuation of current money supply growth will add just 2.5 percent to the price level each year in the long-run. And if noninflationary real GNP growth is nearer to 4 percent, as we believe, then a continuation of current money supply growth will contribute only about 1 percent to inflation.

If inflation stays above 4 percent in 1990, it is because past growth in money supply, which remains disinflationary without the Fed's high interest rate policy, perversely becomes inflationary when the Fed forces rates up. Minimal economic growth due to high interest rates keeps inflation high and promotes mistaken calls for even higher interest rates when money supply growth otherwise would be disinflationary if the economy were allowed to grow.

If economic growth is stifled by raising tax rates, adding new regulations, enforcing new mandated benefits or other destructive policies, measured inflation will remain high or rise even with restrained money supply growth. The appropriate response is to rescind those non-monetary policy actions.

The current situation is more complicated. Not only does the Fed have to contend with non-monetary policies that inhibit economic growth, but also its own high interest rate policy, which is largely responsible for the current slowdown. The Fed now confronts the task of reducing interest rates while holding the line on money supply growth. Can the Fed with only one policy instrument — the manipulation of bank reserves — set in motion a policy of subdued reserve growth to quell an increase in money supply growth while at the same time allowing interest rates to fall? The simple answer is yes.

This conclusion contrasts with the view of many analysts, including those at the Fed, who mistakenly believe that too much real GNP growth creates inflation. They believe that people will spend and borrow too much when their incomes are increasing, and that as the number of employed rises the economy's capacity to produce goods and services will be strained. As a result of these two factors, the fear is that new demand will go to price rises rather than additional output. Thus, inflation can only fall if actual growth is at or below potential.

But this tired, Keynesian analysis of "overheating" and runaway inflation makes no sense. There are ample market-driven restraints to a burgeoning spending and borrowing spree. When the economy expands in this fashion, interest rates rise of their own accord, the Fed does not have to engineer such a rise. High interest rates deter some new borrowing and spending and bring any "excessive" private demand stimulation to a halt. On the supply side of the competitive economy, business investments during an expansion raise worker productivity so that scarcer labor goes further in making products and satisfying new demand without runaway price increases.

From the late 1960s to the beginning of the 1981-82 recession, it was primarily excessive money supply growth that contributed to increases in inflation. Fed policy at that time was designed to overcome cost increases in the economy from tax rate hikes, increasing regulations, occasional supply shocks, and increasing mandated benefits such as a higher minimum wage. Fed actions were also designed to help finance new government expenditures with new money. Inflation became worse, however, because government policies

that raised business costs also curtailed real GNP growth in the 1970s. Stagflation was the result.

Tax rate cuts and less regulation started the current expansion and gave the economy a period of disinflation. From 1983 on, the Fed has resisted the temptation to fend off any rising business costs when they occurred. Except for a time in 1985 and 1986 when trying to reduce the value of the dollar, the Fed kept money supply growth well below 1970 rates.

Inflation did indeed rise in late 1987 as a direct result of Fed policy in the previous two years. Even though this rise in inflation was predictable because of 1985 and 1986 Fed actions to raise money supply growth, the Fed lost patience and embarked on its ill-fated interest rate plan. But at no point was the economy in danger of "overheating." Economic growth in 1988 was fairly strong and inflation rose very little. Yet the Fed continued its "overheating" rhetoric and forced interest rates up some more.

Eventually, economic growth slowed from rising business costs. If the Fed had been patient enough to let subdued money supply growth work to curtail aggregate demand without putting the supply-side of the economy at risk, inflation would have declined. If the Fed in 1990 will admit that enough is enough and keep money supply growth to the midpoint of its target range of 5 percent, then whatever inflation we get above 2.5 percent can be claimed to have been the consequence of new business costs that are continually imposed from a variety of government laws and regulations as well as lingering high interest rates — all of which act to reduce real GNP growth.

Interest rates stay high because there is now a sizeable "Fed premium" built into credit markets. Unpredictable and uncertain Fed forays into credit markets raise interest rate risk, especially on short-term rates, and discourage lending at lower rates. Even though economic growth and credit demand have fallen, interest rates will not fall until the Fed abandons its secret credit market interventions or until inflation clearly falls to dissuade Fed credit market actions. If the Fed resists credit market interventions and indicates that rates need go no higher, that will be enough to reduce the Fed premium, and interest rates can fall even though Fed money supply policy could be described as being tight.

Congress and the administration are unlikely to help reduce inflationary pressures. They are in the process of settling on a budget for fiscal year 1991 that currently contains $13.9 billion in new taxes. This would be the largest tax increase since the one that was passed in 1986 and would cut economic growth significantly. Proposed tax increases, if passed, would raise business costs and slow economic growth, but would not significantly reduce the burden of government spending on the economy.

Government spending is the real economic policy problem. Federal government spending as a portion of GNP now stands at just above 22 percent. In the thirty years prior to 1980, federal spending averaged 18 percent of GNP. Yet, it escalated to above 24 percent in the mid-1980s and has stubbornly remained high. Only tax cutting will reduce government spending as a portion of GNP and get it back to historical levels.

Tax cuts have the benefit of reducing business costs and allowing people to keep more of what they earn. If significant tax cuts were enacted and government spending was quickly brought into line with revenues, a sizeable "prosperity dividend" would result lifting real GNP permanently. This would have the added benefits of directly reducing inflation and removing the necessity of inflationary Fed financing that has characterized the past twenty-five years.

The debt burden — outstanding government debt as a portion of nominal GNP — has fallen since 1986 as strong economic growth has taken hold and the budget deficit has been reduced. If tax rates can be cut and government spending quickly reduced so that beginning in 1993 the government runs a balanced budget, the debt burden can be reduced to 16 percent of GNP by the year 2008. With economic growth and some expected inflation, a constant level of debt automatically declines as a share of GNP and becomes less of a burden.

The only sure way to get spending down is to contain tax increases and insist upon tax cuts. Unfortunately, the budget deliberations are moving away from this proven method to the detriment of the U.S. economy.

If serious policy mistakes can be avoided, the economic expansion should have a much longer life. The American economy is still healthy and competitive. It could be healthier and more competitive if interest rates were lower, tax rates were cut, regulations were rolled back and mandated benefits were rescinded.

Economic growth will not climb anywhere near its potential in 1990 because policy mistakes have already been made. With growth so low, the economy's tolerance for new mistakes is limited. Regretfully, such a serious condition may be the only brake on poor policy-making in 1990. Even so, the pessimists on the economy typically posit an incorrect remedy to the deficit — increased taxes. They ignore a simple truth: tax increases merely guarantee lower economic growth, more hardship for working people and greater fiscal stress for government.

RECENT ECONOMIC POLICY DIVISION PAPERS

Dr. Lawrence A. Hunter and Dr. William K. MacReynolds, "Fool's Gold: Planning for a Budget Surplus," *Economic Snapshot*.

Dr. William K. MacReynolds, "Deposit Insurance Reform," *Economic Snapshot*.

Dr. Donald R. Leavens, "The Invisible Costs of Government Spending."

A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States

May/June 1990

CAN INFLATION BE REDUCED?

We remain cautiously optimistic for the economic outlook during the last three quarters of 1990. Exports will continue to outpace imports, and consumer spending, while not strong, appears adequate to keep real GNP growth near 3 percent for the rest of the year. Business inventories actually fell in the first quarter of 1990 and should increase for the rest of the year as industrial production picks up.

The caution results from the fact that estimates of future inflation are higher than in our last outlook. And interest rates, especially long-term rates, will not come down as sharply as we predicted in the past. The reason for these changes is the increased uncertainty and instability to the economy and credit markets as a result of past and present Fed policy.

During the fourth quarter of 1989 and the first quarter of 1990, interest rates rose, economic growth slowed and inflation jumped upward. The decline in growth was the medicine Fed policy-makers have been counting on to reduce inflation and simultaneously bring interest rates down. However, high interest rate policy that has "cooled down" economic growth has produced none of the supposed "benefits" of slow growth. In fact, inflation is now worse than when growth peaked in late 1987 and interest rates, especially long-term rates, have remained near their highs of the last two years.

The table indicates the extent of the slowdown by taking an economic snapshot at six-month intervals. For example, in the last two quarters for which reported data exists, the economy grew at an annual rate of 1.2 percent. During this time, every economy-wide inflation measure reached a three-year high. The table shows that economic growth peaked at the end of 1987 and the beginning of 1988 and has fallen ever since. However, inflation by all measures averaged a higher amount from the second quarter of 1988 until the present than prior to the economic slowdown.

The slowdown is directly responsible for the shortfall from projected government revenues in 1990 that is sending the budget deficit upward. The slowdown is also generating a marked decline in the number of new jobs and sending the unemployment rate higher. Persistently high interest rates have adversely impacted the housing, construction and automobile industries.

Real estate values have been placed in doubt in many areas of the country thus lowering the liquidity of a vast amount of real assets. Commercial bank loans have declined and large time deposits have left depository institutions and gone into the short-term commercial paper market. Small businesses find it more difficult to obtain loans as the economic slowdown raises doubts about future economic growth and the value of collateral that stands behind loans.

TABLE 1

REAL GNP GROWTH AND SELECTED INFLATION MEASURES

PERIOD	REAL GNP GROWTH	PERCENT CHANGE GNP DEFLATOR	PERCENT CHANGE GNP FIXED WEIGHT INDEX	PERCENT CHANGE CPI	PERCENT CHANGE CORE CPI
89:4-90:1	1.2%	4.5%	5.2%	6.7%	6.1%
89:2-89:3	2.8	3.9	3.9	3.8	3.6
88:4-89:1	3.2	4.3	4.5	5.1	5.0
88:2-88:3	3.4	4.4	4.9	4.9	4.3
87:4-88:1	5.3	2.4	3.7	3.7	4.9
87:2-87:3	4.7	3.3	3.9	4.1	3.8
86:4-87:1	3.8	2.4	3.6	4.3	4.4

Compounding this is the fact that thrifts and commercial banks are struggling to meet new, higher capital standards and bank examiners from the Comptroller of the Currency are more uniformly marking to market bank assets and the collateral banks hold to back up loans. The rather abrupt change in bank examination actions has caught many banks by surprise resulting in a deterioration of many bank assets making it more difficult for banks to raise new capital.

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Dr. Richard W. Rahn, Vice President and Chief Economist
Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1990 - 1991

Prepared by the U.S. Chamber of Commerce

June 1990

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS									YEARS		
	Actual				Forecast					Actual	Forecast	
	89/4	90/1	90/2	90/3	90/4	91/1	91/2	91/3	91/4	1989	1990	1991
GROSS NATIONAL PRODUCT												
Nominal GNP	4.6	7.0	6.8	7.1	7.2	6.8	6.8	6.7	6.5	7.2	6.5	7.1
Real GNP	1.1	1.3	2.9	3.2	3.5	3.1	2.6	2.9	2.4	3.0	2.2	3.0
Consumption	0.5	2.4	2.5	3.0	3.0	3.1	2.8	3.0	2.6	2.7	2.6	3.0
Residential Investment	-1.1	10.8	-4.6	1.5	3.5	0.8	1.4	2.3	-1.3	-2.9	-0.4	1.1
Nonresidential Investment	-5.4	6.4	0.7	2.3	4.1	4.8	3.8	3.6	2.4	3.3	2.4	3.7
Equipment	-6.9	6.8	3.0	2.2	4.2	5.6	4.2	3.8	2.7	5.0	2.9	4.1
Structures	-0.3	4.7	-6.9	2.6	3.8	2.1	2.5	2.8	1.5	-1.8	0.7	2.1
Exports	9.4	7.7	5.1	6.6	7.4	6.4	6.2	5.8	5.1	11.1	7.2	6.5
Real Net Exports (82$B)	-47.2	-40.3	-38.5	-35.2	-30.6	-28.2	-24.7	-21.1	-17.7	-52.6	-36.1	-22.9
Imports	2.2	2.7	3.7	4.2	4.3	4.7	3.9	3.5	3.0	6.1	4.1	4.2
Government Purchases	2.6	3.1	0.1	1.2	-2.1	0.7	-0.3	-0.1	0.6	2.7	1.3	-0.1
Final Sales	1.1	4.1	1.6	2.8	3.0	3.0	2.6	2.8	2.4	3.1	2.6	2.8
Change in Business Inventories (82$B)	22.2	-5.9	7.4	11.2	16.3	17.6	17.5	18.6	19.2	21.9	7.3	18.2
Industrial Production	0.2	1.1	2.3	3.6	4.4	3.3	2.0	1.8	1.2	1.7	1.1	3.1
New Car Sales (mill.)	8.7	9.7	9.4	9.5	9.7	9.8	9.6	9.6	9.6	9.9	9.6	9.7
Domestic Car Sales (mill.)	6.2	7.0	6.7	6.9	7.0	7.1	7.0	7.0	6.9	7.1	6.9	7.0
New Housing Starts (mill.)	1.35	1.45	1.29	1.31	1.35	1.44	1.39	1.41	1.34	1.39	1.35	1.39
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.3	5.2	5.4	5.5	5.4	5.3	5.2	5.2	5.2	5.3	5.4	5.2
Compensation	6.0	3.9	5.3	4.7	4.8	5.4	4.9	4.7	4.5	5.5	5.1	5.0
Productivity	0.5	-1.0	1.9	2.0	1.7	1.6	1.5	1.7	1.0	0.9	1.0	1.7
Unit Labor Costs	5.5	4.9	3.4	2.7	3.1	3.8	3.4	3.0	3.5	4.6	4.3	3.3
Consumer Price Index	4.9	8.5	4.0	4.3	3.9	4.4	3.8	3.7	4.5	4.6	4.9	4.1
Implicit GNP Deflator	3.2	5.7	3.9	3.9	3.7	3.7	4.2	3.8	4.1	4.1	4.2	3.9
Prime Interest Rate (%)	10.5	10.0	10.0	9.7	9.5	9.3	9.0	8.7	8.5	10.9	9.8	8.9
3-mos. Treasury Bill Rate (%)	7.7	7.8	7.5	7.3	7.1	7.0	7.0	6.9	6.7	8.1	7.4	6.9
Corporate Bond Rate (%)	8.9	9.2	9.3	9.1	9.0	8.8	8.5	8.4	8.3	9.3	9.1	8.5
Real Personal Disposable Income	2.4	2.2	2.4	4.0	3.1	2.9	2.3	3.1	3.4	4.0	2.8	3.0
Changes in Profits from Current Production ($B)1	-9.3	1.9	6.7	9.8	8.4	5.1	3.6	1.2	-4.6	-27.3	-1.7	20.1

*Projected change from fourth quarter 1989.

[1]Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This month's forecast table contains advance estimates of the National Income and Product Accounts for the first quarter of 1990. The nation's money supply M(2) is assumed to grow by 6.5 percent in 1990 and 4.4 percent in 1991. The trade weighted exchange value of the dollar rises by 2.0 percent in 1990 and 4.4 percent in 1991.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

These recent, adverse developments came about during a time when the Fed has been attempting to ease away from the restrictive monetary policy that began in mid-1988 and became harsher in late 1988 and through the first half of 1989. Since June 1989, the Fed has allowed the fed funds rate, the rate at which banks make overnight loans to one another, to fall from almost 10 percent down to 8.2 percent in January 1990.

The Fed has kept this rate stable despite wide swings in other interest rates. To keep the fed funds rate stable since January when other rates have been rising, the Fed has had to keep bank reserve growth high. Consequently, the monetary base has grown by an annual rate of 9 percent in 1990 after rising by just 3 percent in 1989. Growth in other monetary aggregates have undergone wide swings in the past year as monetary policy has been erratic and unpredictable.

FIGURE 1

NOMINAL AND REAL GNP GROWTH

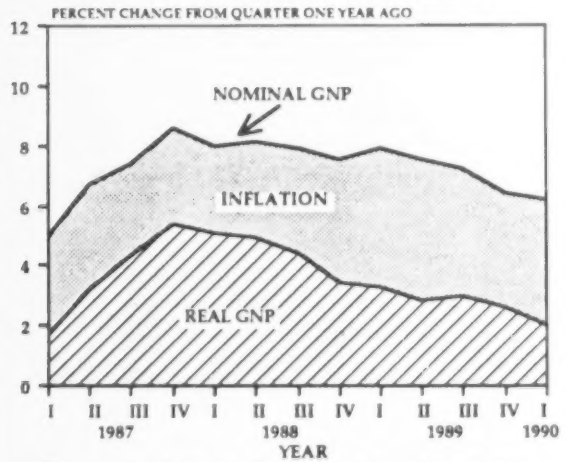
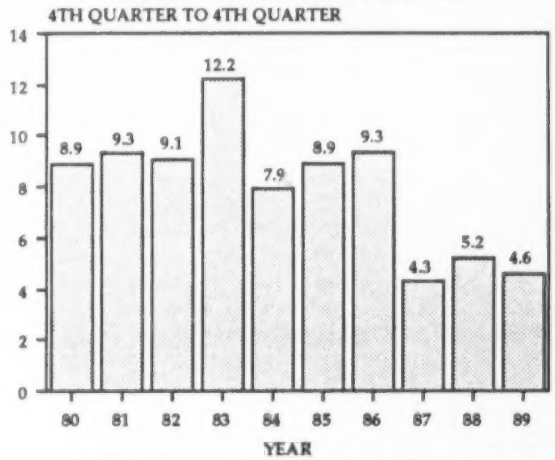


Figure 1 shows what has been happening to nominal GNP growth (this is a measure of current dollar aggregate demand growth), real GNP growth and the difference between the two, which is equivalent to inflation as measured by the GNP deflator. Starting with the first quarter of 1988, both real GNP growth and aggregate demand growth (nominal GNP growth) began to fall from their peaks at the fourth quarter of 1987. However, from the end of 1987 real GNP growth has fallen faster than nominal GNP growth and has resulted in greater inflation as measured by the vertical gap between the two curves.

The decline in real GNP growth was clearly the result of the Fed's high interest rate policy. Real GNP growth fell more rapidly at the end of 1988 and then leveled off before falling strongly in the fourth quarter of 1989 and the first quarter of 1990. The respite in inflation, as shown in the table, occurred during the second and third quarters of 1989 when real GNP growth did not fall. The implication of the past three years is clear: inflation is lower when real economic growth is higher. Inflationary pressures are enhanced by high interest rate policy and slow economic growth.

FIGURE 2

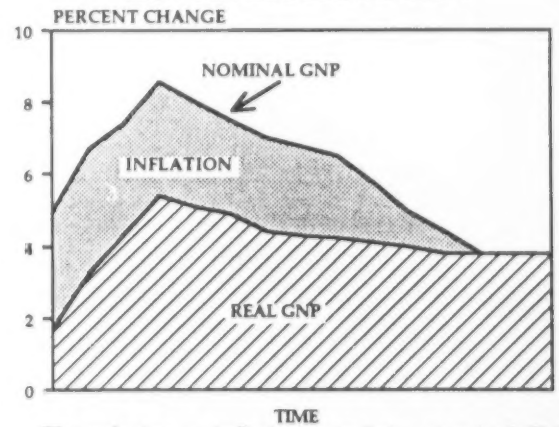
GROWTH IN MONEY SUPPLY M2



In 1987, M2 growth, as shown in Figure 2, fell to about one-half of what it was in 1986. Since the end of 1986, it has averaged about 5 percent growth per year. By keeping M2 growth below nominal GNP growth, there has been pressure on aggregate demand growth to decline. That decline has been gradual from over 8 percent at the end of 1987 to 6.2 percent in the first quarter of 1990. Such a decline alone should have been sufficient to bring inflationary pressures and inflation downward if real economic growth could have stayed near its expansion-long trend of 4.0 percent. However, rather than lessening, the inflation problem has actually been exacerbated by ill-conceived Fed policy designed to bring real economic growth down.

FIGURE 3

HOW TO REDUCE INFLATION



The solution to inflation is to bring nominal GNP growth down so that it matches real GNP growth potential as hypothetically depicted in Figure 3. Ultimately, to rid the economy of inflation, it is necessary to create adequate new money to facilitate maximum economic growth with stable prices -- no more, no less.

Thus, the Fed was on the right track in 1987 when it reduced money supply growth from rates that had

prevailed in the previous two years. By the first quarter of 1988, nominal GNP growth began to fall and real GNP growth was backing off slightly from higher than trend growth. But the Fed became impatient. Relying on erroneous theories of how the macroeconomy works -- the Phillips Curve trade-off between unemployment and inflation -- the Fed opted to cool real GNP growth directly. That policy resulted in today's situation where the gap between nominal GNP growth and real GNP growth has not been closed. *And this, of course, gives rise to an apparent paradox. Today, with such low real economic growth, even aggregate demand growth of just over 6 percent is more inflationary than aggregate demand growth of over 8 percent was in late 1987. Clearly the danger the economy faces from further inflation is because real GNP growth is too low.*

The current confusion over inflation and what to do about it stems from a fundamental misconception of how free economies operate. Since the 1930s, the economics profession, the policy-makers they advise, most financial writers and many in the business community have suffered under the delusion that free markets are inherently fragile, subject to failure at every turn and require constant manipulation and fine-tuning by technocrats.

One such alleged failure is inflation. The basic misconception regarding inflation is that free markets spontaneously produce excess demand (i.e., free market economies tend to grow too fast and "overheat") which sets off a self-perpetuating round of "cost-push" inflation.

Of course, one of the great insights of economics -- an insight that we need to relearn it appears -- is that free-market economies are self-adjusting. They cannot grow too fast for any length of time, because the price mechanism acts as a kind of governor on the system. The only way cost-push inflation can take hold is if the central bank validates otherwise temporary "excess demand" by accommodating it with excess money creation. Inflation is the result, but the central bank, not excessive economic growth, is the culprit.

The Keynesian notion of a trade-off between unemployment and inflation, the so-called Phillips Curve, was never an accurate theory of the macroeconomy. What the econometricians have mistaken for a theoretical trade-off between unemployment and inflation is really a short-run statistical phenomenon that easily could be manufactured by the actions of central banks. If the central bank attempts to offset a decline in economic growth caused by excessive government spending and regulation, the result is a temporary decrease in unemployment and an increase in inflation -- the Phillips Curve tradeoff. However, as the excessive money supply generated by the central bank works its way through the economy, inflation and unemployment will rise again, this time to a new higher level. If the Fed attempts to push this unemployment down, it must jolt the economy again with another dose of inflationary money growth. Again, unemployment dips with inflation rising -- the Phillips Curve trade-off.

In the short run, the Fed may, in fact, generate a Phillips Curve trade-off but over the long-run, inflation and unemployment -- far from moving opposite one another -- are moving in tandem to higher and higher levels, and the economy experiences the kind of stagflation we saw in the 1970s. In the February 1988, *Economic Report of the President*, the Council of Economic Advisors reports that "recent data provide little evidence of a tradeoff between inflation and unemployment." The experience in the 1980s has been declining unemployment with stable inflation.

There is no theoretical economic reason to experience a Phillips Curve trade-off. If central banks gradually reduce inflation by a slow and steady reduction in the growth of the money supply and if this policy is known and understood, interest rates do not need to rise from any lack of new bank reserves and economic growth can proceed apace with falling unemployment.

If economic growth is too strong, the free market will produce a rise in interest rates without help from the Fed. However, in early 1988, the economy was not "overheating" of its own accord. Any excessive stimulus was coming from too much money supply growth in 1985 and 1986 which already was being corrected by subdued money supply growth. The problem was that the Fed was looking at very short-run changes in the economy and measuring them against expectations of an optimal long-term path of economic growth.

Unfortunately, no one precisely knows what the growth potential is for the U.S. economy. Keynesian economists and many members of the Fed believe noninflationary economic growth potential lies near 2 percent growth. They have estimated that today's actual real GNP exceeds potential GNP so that the economy will have to experience below 2 percent growth for a year or more to rid the economy of inflationary pressures.

Yet in the early 1980s, Fed estimates of growth potential were above 3 percent. *The Fed's turn toward a pessimistic assessment of future growth and its implementation of policy based upon such pessimism is the real cost to the economy of efforts to lower inflation.*

Today's inflation rate is a clear indication that Fed theories of the economy are faulty. It is also clear that the Fed is further away from price stability today than when it set out to quell inflationary pressures in mid-1988. The Fed can back off from high interest rate policy or even interest rate targets if it will announce its intention to hold down aggregate demand growth as long as it takes to rid the economy of inflation. But it cannot continue to threaten the economy with short-term adjustments to interest rates and hope to get inflation down. Inflation will come down only when the economy is allowed to grow to its potential, which is well above where growth lies today.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

July/August 1990

RECESSION

For the first time since 1981, the U.S. Chamber of Commerce is forecasting an economic recession. We anticipate that the economy will grind to a virtual standstill during the third quarter of this year and actually contract by 1.4 percent in the fourth quarter. Our forecast shows the economy continuing to experience negative real growth, -1.1 percent, in the first quarter of 1991 and practically no growth in the second quarter.

The sad state of the American economy is the direct consequence of misguided economic policy. Although Congress and the Administration must share substantially in the blame — they have increased the tax burden, allowed federal spending, once again, to get out of hand and piled on excessive new regulations — the greatest responsibility for this looming recession lies at the doorstep of the Federal Reserve Board (Fed).

It is the age old problem of the Fed trying to fine-tune the economy. For over two years, the Fed has labored under the mistaken fear that economic growth causes inflation and has pursued a credit policy designed to slow real economic growth. During this time, we have warned that the Fed's intentional slowdown policy ultimately would produce a recession. We have also claimed that slowing down the economy is an unnecessary and unproven method to reduce inflation. Both of our long-held points of view appear to be true.

Although there are still signs of positive growth from continued export expansion, most of today's economic indicators show a weak and rapidly falling economy. Revised GNP statistics for 1987 through the beginning of 1990 show what we had feared all along actually did occur. Real GNP growth in 1989 was much weaker than previously estimated coming in at 2.5 percent, down from a healthy 4.5 percent rate in 1988.

Comparing the fourth quarter level of real GNP in 1989 to the fourth quarter level of real GNP for the previous year, real GNP growth was 1.8 percent, almost one-half the 1988 fourth quarter over fourth quarter growth rate of 3.5 percent. Through the second quarter of 1990, real GNP growth has deteriorated further to just 1.2 percent over the second quarter of 1989.

The economy has never been stable at such low growth rates. Whenever real GNP growth stays between 1 and 2 percent for at least a year, the economy has either rebounded sharply toward trend growth or fallen into the tank. Unfortunately, there are no signs of an imminent rebound.

On the supply-side of the economy, factory orders have stopped increasing, unfilled orders are declining and unwanted inventories are beginning to accumulate. This suggests that industrial production, buoyed primarily by increased automobile production in the last six months, will decline throughout the remainder of 1990 and into 1991. Services sector employment has stopped absorbing the losses in factory jobs the economy has experienced over the past 14 months. Private sector employment fell by 45,000 jobs in July and the unemployment rate jumped to 5.5 percent. Job growth in retail sales and services industries has slowed considerably in 1990, leading to a rising rate of unemployment among teenagers and lower skilled workers.

The construction and housing industries are already in a recession. There are more than 100,000 fewer jobs in construction than there were last fall. The economic slowdown has produced a credit crunch on small business. As the Chamber's recent "Business Ballot" survey indicates, 21.4 percent of all businesses have experienced difficulty in obtaining credit in the first six months of 1990. Normally only 6 to 8 percent would experience difficulty. The credit crunch has impacted smaller businesses, the key force in generating economic growth, the most. And, although it has hit all regions of the country, the northeast, west and south have been affected most severely.

The economic slowdown has reduced personal income growth and led to a decline in consumer spending growth. Falling real estate values have added uncertainty to the future value of household asset holdings, further depressing consumer spending. As households save more and consume less, the economy will fall from extremely low

Economic Outlook, published bimonthly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year which includes *Policy Working Papers*. Individual copies of the *Outlook* can be purchased for $7.50 per copy.

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Dr. Richard W. Rahn, Vice President and Chief Economist
Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1990 - 1991

Prepared by the U.S. Chamber of Commerce
August 1990

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS			
	Actual		Forecast						Actual Annual Average		Forecast	
	90/1	90/2	90/3	90/4	91/1	91/2	91/3	91/4	'83-'88	1989	1990	1991
GROSS NATIONAL PRODUCT												
Nominal GNP	6.7	5.8	4.8	3.2	4.8	5.0	5.2	5.4	7.5	6.7	5.3	4.8
Real GNP	1.7	1.2	0.5	-1.4	-1.1	0.4	1.9	2.4	4.0	2.5	1.0	0.1
Consumption	1.1	-0.3	0.9	-1.8	-0.9	0.0	1.5	1.7	4.1	1.9	0.7	-0.2
Residential Investment	15.1	-13.5	-10.7	-6.1	-2.3	1.4	3.7	5.4	10.8	-4.1	-3.7	-2.9
Nonresidential Investment	5.0	-6.1	-0.4	-5.6	-3.1	0.3	3.6	0.6	4.8	3.9	0.1	-1.7
Equipment	5.7	-6.2	0.3	-4.3	-3.3	0.6	4.2	1.7	8.5	5.2	0.4	-1.2
Structures	2.3	-6.0	-2.6	-9.9	-2.6	-0.8	1.6	-2.9	-2.6	0.0	-1.0	-3.3
Exports	11.2	-3.7	5.8	4.3	5.5	6.2	5.8	5.1	6.7	11.0	6.2	5.0
Real Net Exports (82$B)	-35.4	-46.5	-40.2	-35.5	-28.8	-21.8	-17.5	-15.0	-88.7	-54.1	-39.4	-20.8
Imports	2.5	3.2	1.6	1.3	1.2	1.8	3.1	3.5	10.5	6.0	3.4	1.9
Government Purchases	2.9	6.2	-0.6	-2.1	-0.4	-2.9	-1.7	2.6	3.2	2.3	2.2	-0.8
Final Sales	3.8	-1.5	0.6	-0.7	-0.5	0.2	1.6	2.1	3.8	2.5	1.2	0.1
Change in Business Inventories (82$B)	-2.2	26.2	25.6	18.2	11.8	13.8	16.7	19.4	21.6	23.8	17.0	15.4
Industrial Production	0.6	3.5	1.9	-2.3	-1.8	1.1	2.2	2.8	4.9	1.7	1.0	0.2
New Car Sales (mill.)	9.7	9.6	9.8	9.3	8.9	9.2	9.4	9.5	10.5	9.9	9.6	9.2
Domestic Car Sales (mill.)	7.0	6.8	7.0	6.5	6.1	6.4	6.8	6.9	7.6	7.1	6.8	6.5
New Housing Starts (mill.)	1.45	1.20	1.18	1.15	1.16	1.19	1.24	1.29	1.68	1.39	1.24	1.22
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.2	5.3	5.6	5.9	6.2	6.4	6.7	6.8	7.2	5.3	5.5	6.5
Compensation	3.2	5.6	4.7	4.8	4.1	3.6	5.2	4.5	4.3	3.0	3.7	4.5
Productivity	-1.9	1.6	1.7	-1.3	-0.9	0.6	1.8	1.4	1.9	-0.3	-0.5	0.2
Unit Labor Costs	5.2	3.9	3.0	6.1	5.0	3.0	3.4	3.1	2.3	3.3	4.2	4.3
Consumer Price Index	8.5	3.5	5.1	6.3	5.4	4.3	3.6	3.3	3.5	4.6	4.8	4.9
Implicit GNP Deflator	4.8	4.4	4.2	4.6	5.7	4.6	3.4	3.3	3.3	4.1	4.2	4.7
Prime Interest Rate (%)	10.0	10.0	10.0	9.8	9.5	9.3	9.0	8.8	9.8	10.9	10.0	9.1
3-mos. Treasury Bill Rate (%)	7.8	7.7	7.5	7.3	6.8	6.5	6.2	5.9	7.8	8.1	7.6	6.4
Corporate Bond Rate (%)	9.2	9.4	9.3	9.2	9.0	8.8	8.6	8.4	10.7	9.3	9.2	8.7
Real Personal Disposable Income	2.4	0.5	1.1	-2.3	-0.8	0.8	1.1	2.3	3.6	2.4	1.2	0.0
Changes in Profits from Current Production ($B)1	5.9	6.7*	-3.6	-6.8	-3.2	0.9	5.6	7.1	29.8	-26.0	-13.3	-3.2

[1]Corporate profits with inventory valuation and capital consumption allowances.
*Based on forecast for second quarter.

FORECAST ASSUMPTIONS

This month's forecast table contains final estimates of the National Income and Product Accounts for the first quarter of 1990. The nation's money supply M(2) is assumed to grow by 3.9 percent in 1990 and 5.2 percent in 1991. The trade weighted exchange value of the dollar falls by 7.4 percent in 1990 and rises by 2.0 percent in 1991.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

economic growth into a recession.

The recent rise in oil prices from Iraqi adventurism in the middle east acts as a tax on consumers and producers. High oil prices are likely to persist for several months, adding impetus to the slowdown and mildly deepening the recession. A rise in oil prices of about $5 per barrel is likely to persist well into 1991 and will reduce annual real GNP growth by about 0.5 percentage points.

Thus, consumers who are suffering from a loss of liquidity in their income and assets will not lead a rebound in economic activity as previously anticipated. In fact, from the combination of higher taxes and higher prices, personal disposable income will fail to grow at all in 1991. Surveys already indicate that consumer confidence in the economy is waning. This is already reflected in extremely low consumption spending growth for the first six months of 1990.

Declining corporate profits will continue to keep business investment from expanding. High interest expense, rising wages, and low productivity growth will continue to depress profits and production and lead to a decline in business investment expenditures.

Finally, there is some reason to doubt that export expansion will continue to be robust. Canada is already officially proclaiming that a recession there is at hand. U.S. exports of capital equipment to European markets have begun to slow from 1989 rates, suggesting that export growth will be insufficient to forestall a recession.

Stagnant U.S. economic growth, higher taxes, increased oil prices and rising real interest rates in the rest of the world are causing the dollar to decline against most major currencies. Our concern is that U.S. policy makers may intervene to stop what is a necessary adjustment to the unfavorable economic circumstances under which the U.S. economy operates. If they do so, U.S. exports will suffer and, unless the dollar falls sufficiently, foreign investors will lose interest in U.S. government and corporate securities, preferring to invest in securities where real returns are greatest. Such policy action would merely delay the eventual decline in the dollar at great cost to the economy.

Until this month, our forecasts have assumed that policy corrections would reverse the anti-growth effects of federal policy over the past two to three years in time to avert a recession. But the combination of higher than expected taxes, greater than anticipated federal spending increases emanating from the budget deficit negotiations, and continued high interest rate policy by the Fed have dashed any hope of a policy turnaround.

It is unfortunate for Americans that the impending recession may be the only catalyst to induce policy makers to rethink their present path. If policy corrections can be made by this fall and new pro-growth policies are enacted, the economy will begin to grow again during the last six months of 1991. We have always believed the economy to be strong and resilient and growth potential to be sufficient to generate noninflationary growth of near 4 percent, absent policy mistakes.

All economists would agree that raising taxes during a recession is foolhardy. And most economists would posit that with such slow growth as we have today, a tax increase could tip the economy into recession. However, many economic observers are of the opinion that deficit reduction in 1991 is the overriding economic concern. They propose a policy mix of "fiscal restraint" (which paradoxically includes more taxes to keep spending growth higher than it otherwise would be) through a lowered deficit — no matter how deficit reduction is achieved — and expansionary monetary policy to settle down credit market fears of a recession. But the present economic slowdown and the likely recession have already raised the deficit in 1990 and will increase the budget deficit further in 1991 regardless of the amount of fiscal restraint finally agreed upon. The worst fears of credit market participants are about to come true, and nothing can be done about it.

The rising deficit in 1990 comes from slower growth in revenues than the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) predicted would occur last fall. The reason revenue growth is at 5 percent instead of the hoped for 8 percent is the slowdown in the economy. Moreover, even though in July both CBO and OMB adjusted projected revenue growth downward in 1990, their forecast for 1991 real GNP growth stands above the current consensus for private forecasters of the "Blue Chip Economic Indicators."

Our present forecast for real GNP growth for fiscal years 1990 and 1991 is 0.5 percent and 0.9 percent, respectively. CBO's July 1990 forecast calls for higher real GNP growth, 2.1 percent and 2.4 percent, respectively, for 1990 and 1991. Based upon CBO rules of thumb that relate revenues and federal expenditures to GNP growth, if real GNP growth comes in 1.5 percent below what CBO currently projects for 1990 and 1991 as we expect, the budget deficit will be $35 billion more than CBO currently estimates. Thus, of the $50 billion in planned baseline deficit reduction widely discussed by budget summit participants, only $15 billion would go to actual deficit reduction under a low growth scenario.

There is some nascent recognition among the summiteers that deficit reduction will have to be lower than $50 billion for 1991 because the declining economy could not withstand the tax increases of $25 billion or so contemplated under such a plan. New options being discussed call for about $20 billion in deficit reduction for 1991 with an easing of Fed policy. However, this policy package would place undue reliance on the Fed to lower interest rates with expansionary credit policy that is doomed to repeat the mistakes of the late 1970s and give us stagflation and a deep recession.

Policy makers must rethink the whole problem. The reasons the deficit is rising are that there has been too little economic growth, cutting revenue growth well below last year's projections, and there has been far too great an increase in federal spending. Federal spending is once again out of control. Spending in the current fiscal year is now expected to grow by 10.5 percent, twice the rate that was anticipated last year and more than double the current inflation rate. Impatient for the sluggish budget negotiations to end, Congress has already voted on several major appropriations bills for the upcoming fiscal year which would raise federal spending by a whopping 11.4 percent for 1991. This is far in

excess of the July 1990 OMB baseline projections for 1991 that call for a 7.2 percent rise in spending.

In a weak, recessionary economy federal spending increases in excess of inflation would harm the economy greatly. The government is the first to receive funds either from people's income in the form of taxes or from savings in the form of loans. If government spending grows faster than nominal GNP, funds are taken out of private hands and given to the government, thus reducing whatever real economic growth exists.

Many forecasters confuse the wide interest rate spread between government and corporate securities as a sign of potential economic expansion in the private sector. It is not. Rather it shows a deterioration of private credit quality as a result of the economic slowdown. In addition, the large spread between government and private securities reflects uncertainty in the economy and the desire among lenders to invest in safer, more liquid assets.

When the Fed recently acted to reduce short-term government interest rates with open market purchases, long-term government rates shot upward. Credit markets correctly perceived that Fed loosening was a signal that the probability of recession was higher. This meant that federal spending was going to rise faster than markets had previously anticipated, and the public sector's demand on credit markets would rise.

This is the nexus that policy-makers would like to ignore, blaming higher interest rates instead on the deficit. Empirical evidence shows that when the actual budget deficit rises, interest rates often fall and vice versa. Long-term interest rates are determined primarily by monetary policy and government spending. When the likelihood that federal spending will rise as a portion of nominal GNP increases, long-term interest rates will rise. And when the Fed is apparently acting to accommodate such a rise in spending, interest rates rise more.

To reduce the budget deficit, reduce interest rates, and cut inflation it is necessary to enact pro-growth tax cuts and restrain the growth in government spending to no more than the expected rate of inflation. Keeping spending growth to 4 percent in 1991 is equivalent to an "across the board sequester" of $40 billion. That would exceed the budget deficit impact of a projected loss of revenues and extra spending in 1991 as a result of the economic slowdown.

Even with a modicum of spending restraint, the deficit will not fall unless pro-growth tax cuts stimulate permanent improvements in economic growth. A capital gains tax cut to 15 percent, as Senator Kasten has proposed, would rejuvenate the economy by the second half of 1991. Such a tax cut would reduce the cost of capital and raise investment spending. It would also increase government revenues for some time to come and reduce the expenditures necessary to bail out failed thrifts, because it would raise real estate values and lower interest rates.

Coupling that tax cut with a reduction in the Social Security payroll tax on labor and business would leave more income in private hands and restore private spending, especially for those who are most affected by the slowdown. Payroll tax cuts could be phased-in over three years in such a way that the net impact on federal revenues of the two tax cuts would be positive.

More economic growth is necessary to reduce inflation. Unfortunately, the Fed has operated on the opposite principal in recent years. Members of the Fed have steadfastly maintained that economic growth of the type the U.S. experienced throughout the long economic expansion was inflationary. The Fed staff still clings to discredited Keynesian notions that allow it to recklessly destroy jobs and profits when the economy nears a mythical "full employment" level. But empirical evidence shows that higher rates of economic growth are associated with lower rates of inflation. Varying determinations of growth potential and full employment levels do not change this basic fact.

Therefore, tax cuts which invigorate the supply-side of the economy will reduce inflationary pressures. But this will be true only if the Fed can maintain a steady hand on money aggregate growth. By targeting interest rates under a dubious credit policy, the Fed has allowed money aggregate growth to fluctuate wildly over the past two years. What markets need from the Fed instead is confidence that aggregate demand, as measured by nominal GNP growth, will not fall or rise too much. Fed efforts should be focused on hitting its own midpoint target range for M2 growth that will stabilize nominal GNP growth between 5 and 6 percent.

The only question then is how much of the, for example, 6 percent growth in nominal GNP growth will go to real GNP growth and how much to inflation. Tax cuts will raise the portion going to real GNP growth and lower the amount of inflation. Once real GNP growth is restored above 3 percent, the Fed can begin to gradually reduce target M2 growth so as to avoid policies that stifle real GNP growth and exacerbate inflation. In the long-run, M2 growth should be reduced to the level that facilitates long-term noninflationary growth potential of about 4 percent — no more, no less.

There is a real danger, however, that the Fed will re-inflate the economy in an attempt to mask the effects of increased taxes, greater regulation and greater federal spending on the economy. The Fed should avoid this while giving up its disastrous credit policy, letting markets set interest rates instead and allowing the brunt of credit market reaction to budget negotiations reflect budget success or failure.

The outlook for the economy is bleak. It is time to end the anti-growth policies of the past few years. There is nothing to be gained from letting things continue to slide into a longer and deeper recession than must come. Even in the unlikely event that slower growth without negative real GNP growth persists, current deficit reduction schemes and inflation control policies are impossible under these circumstances.

The vaunted economic "soft-landing" was never really in the cards. Trying to prop the economy up falsely with monetary expansion without removing other impediments to growth will cause the economy to tilt at "stall speed" and quickly crash to the ground. Putting the economic pieces back together again would not be accomplished by the end of 1991.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

September/October 1990

LOSING GROUND ON INFLATION AND GROWTH

It is now clear that the economy was barely growing prior to the onset of hostile Iraqi actions in Kuwait. Second quarter real GNP growth slowed to an annual rate of increase of just 0.4 percent. Two years of Fed policy designed to reduce inflation by slowing real GNP growth is the central reason the economy, growing at 5 percent in early 1988, has slipped badly. As a result of the effects of the economic slowdown on government revenues and rising federal spending growth, the budget deficit, along with the middle east crisis, has taken center stage in Washington. The debate over the efficacy of Fed policy actions has been pushed to the back burner.

The deteriorating state of the economy and increasing warnings of a recession with significant inflation by private forecasters have not prompted a change in attitudes by the nation's policymakers. Budget negotiators have continued to press for higher taxes to facilitate enhanced federal spending growth. But higher taxes would further depress real GNP growth and, hence, will not reduce the budget deficit. Spending increases now being contemplated will neither reduce interest rates, help quell inflation nor spur a turnaround in the economy.

When asked by Rep. Lee Hamilton, Chairman of the Joint Economic Committee, what worried him the most, inflation or recession, Federal Reserve Board Chairman Alan Greenspan replied, "Both, at the moment. The outlook for both has deteriorated." That exchange occurred during Greenspan's testimony on the state of the economy in September.

In his written testimony, Greenspan summed up his view of the economy and the likely Fed response:

> **The prospects for weakness cascading throughout the economy do not yet appear compelling, in part because of the tight rein that businesses have been keeping on inventories. Nonetheless, we must remain alert to the possibility of such a development. Whether an efficacious policy response to current developments would seek higher, lower, or unchanged interest rates will depend on the specifics of the situation, which are shifting day by day.**

That last sentence prompted Sen. Paul Sarbanes to "award" Greenspan a medal for obfuscation.

Greenspan focused upon the potential for oil price rises stemming from unrest in the Middle East to create new uncertainty about the future of economic growth and inflation in the U.S. He said, "Despite the general sluggishness in business activity this year, the underlying trend in inflation has not improved. In fact, the core rate of inflation in consumer prices may have crept higher." He concluded that, "Judging from both hard data and more anecdotal reports, we are not — at least not yet — witnessing a cumulative unwinding of economic activity."

The Fed is reticent to act in one direction or another without a new budget plan, and summiteers are waiting until the last moment to present a deficit reduction package. Clearly, Fed inaction represents a pause in its two-year long policy of raising short-term interest rates in an effort to reduce long-term rates. Such a pause has been made necessary, because long-term rates refuse to fall and inflation continues to climb. Having taken the economy to the precipice of recession in a vain effort to contain fears of rising inflation, Fed policymaking is at a standstill.

Fed policy was explicitly designed to slow credit growth, retard the growth in demand and to reduce inflation. The problem with that approach is that it also attacks the supply-side of the economy directly by lowering profits and raising the cost of investment. As a result, businesses, especially smaller businesses, have reduced output and employment growth as is evident from government-provided data and business surveys.

Of course, Greenspan did not mention that the Fed might be culpable for initiating and perpetuating a deteriorating economic situation. In fact, he makes it clear that quarterly declines in real GNP growth are likely to occur as the economy fights off the effects of higher oil prices, neglecting

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Dr. Richard W. Rahn, Vice President and Chief Economist
Dr. Lawrence A. Hunter, Deputy Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section

UNITED STATES ECONOMIC OUTLOOK 1990 - 1991

Prepared by the U.S. Chamber of Commerce

October 1990

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS								YEARS			
	Actual		Forecast						Actual Annual Average		Forecast	
GROSS NATIONAL PRODUCT	90/1	90/2	90/3	90/4	91/1	91/2	91/3	91/4	'83-'88	1989	1990	1991
Nominal GNP	6.7	5.1	5.9	4.0	4.8	5.0	5.2	5.4	7.5	6.7	5.4	5.0
Real GNP	1.7	0.4	0.9	-1.4	-1.1	0.4	1.9	2.4	4.0	2.5	0.9	0.1
Consumption	1.1	0.2	2.2	-1.8	-0.9	0.0	1.5	1.7	4.1	1.9	1.0	0.0
Residential Investment	15.1	-11.2	-16.8	-8.6	-2.3	1.4	3.7	5.4	10.8	-4.1	-4.1	-4.0
Nonresidential Investment	5.0	-4.7	-5.4	-4.9	-3.1	-0.9	3.6	0.6	4.8	3.9	-0.2	-2.3
Equipment	5.7	-3.3	-6.7	-4.3	-3.3	-1.2	4.2	1.7	8.5	5.2	0.1	-2.3
Structures	2.3	-9.0	-1.2	-6.8	-2.5	0.0	1.5	-2.9	-2.6	0.0	-1.2	-2.6
Exports	11.2	-5.0	2.8	2.6	3.9	6.2	5.8	5.1	6.7	11.0	5.4	3.8
Real Net Exports (82$B)	-35.4	-44.6	-42.8	-40.5	-31.4	-20.2	-16.0	-13.6	-88.7	-54.1	-40.8	-20.3
Imports	2.5	0.7	1.5	1.1	-1.8	-0.8	3.1	3.5	10.5	6.0	2.9	0.4
Government Purchases	2.9	6.2	0.0	-1.7	-1.6	-2.9	-1.7	2.6	3.2	2.3	2.3	-0.9
Final Sales	3.8	-0.7	0.2	-0.9	-0.5	0.5	1.6	2.1	3.8	2.5	1.3	0.1
Change in Business Inventories (82$B)	-2.2	9.5	16.8	11.9	5.5	4.9	7.8	10.6	21.6	23.8	9.0	7.2
Industrial Production	0.6	4.1	1.3	-2.3	-3.3	-1.2	2.2	2.8	4.9	1.7	1.0	-0.6
New Car Sales (mill.)	9.8	9.5	9.5	9.1	8.9	8.8	8.7	8.9	10.5	9.9	9.5	8.8
Domestic Car Sales (mill.)	7.0	6.8	6.9	6.5	6.1	6.0	6.0	6.3	7.6	7.1	6.8	6.1
New Housing Starts (mill.)	1.45	1.20	1.14	1.15	1.16	1.19	1.24	1.29	1.68	1.39	1.23	1.22
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.2	5.3	5.6	5.9	6.3	6.6	6.8	6.9	7.2	5.3	5.5	6.6
Compensation	3.2	5.8	4.7	4.8	4.1	3.6	5.2	4.5	4.3	3.0	3.7	4.5
Productivity	-1.9	1.5	1.7	-1.3	-0.9	0.6	1.8	1.4	1.9	-0.3	-0.5	0.2
Unit Labor Costs	5.2	4.3	3.0	6.1	5.0	3.0	3.4	3.1	2.3	3.3	4.2	4.3
Consumer Price Index	8.1	3.7	5.8	6.4	6.5	4.3	3.8	3.6	3.5	4.6	5.4	5.4
Implicit GNP Deflator	4.8	4.7	5.0	5.4	5.8	4.6	3.4	3.3	3.3	4.1	4.4	5.0
Prime Interest Rate (%)	10.0	10.0	10.0	10.0	9.8	9.5	9.3	9.0	9.8	10.9	10.0	9.4
3-mos. Treasury Bill Rate (%)	7.8	7.7	7.6	7.4	7.1	6.8	6.6	6.4	7.8	8.1	7.6	6.7
Corporate Bond Rate (%)	9.2	9.4	9.4	9.6	9.4	9.2	9.0	8.9	10.7	9.3	9.4	9.1
Real Personal Disposable Income	2.4	0.3	-0.2	-2.3	-0.8	0.8	1.1	2.3	3.6	2.4	1.0	-0.2
Changes in Profits from Current Production ($B)[1]	5.9	13.2	4.2	-6.8	-3.2	0.9	5.6	7.1	29.8	-26.0	-7.1	1.5

[1]Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This month's forecast table contains final estimates of the National Income and Product Accounts for the second quarter of 1990. The nation's money supply M(2) is assumed to grow by 4.8 percent in 1990 and 5.2 percent in 1991. The trade weighted exchange value of the dollar falls by 7.4 percent in 1990 and by 1.8 percent in 1991.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

to mention that such a thing would not have occurred if the economy had started from a higher rate of growth.

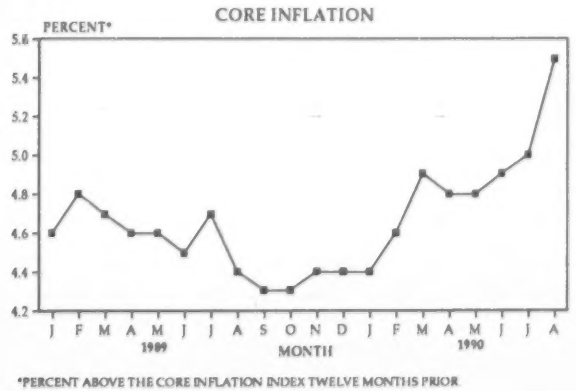
It appears that Fed policy has accomplished little toward reducing inflation. Greenspan, as is his usual custom, did not enumerate any benefits stemming from high interest rate policy. His remarks imply that the economy must suffer a further extended period of high real interest rates without mentioning how rates got so high initially. To reduce long-term interest rates and to prevent "weakness from cascading throughout the economy," Greenspan puts all his hopes on deficit reduction. This can be taken as an admission by the Fed Chairman that monetary policy is incapable of dealing with the dual catastrophe of recession and inflation.

The Fed has only three policy choices: an ad hoc or discretionary policy, a policy based upon a quantity rule, or a policy focused upon price rules. Discretionary policy has failed to produce intended results and the Fed is stuck in a box waiting for developments elsewhere to bring long-term interest rates down. Having chosen a path that gets it no further than its starting point, the Fed is back to square one. It must now choose to focus policy on hitting its target growth rate for the quantity of money or on interpreting signs of inflation from movements in commodity prices. At the present time, credit market uncertainty over possible Fed action is heightened. As a result, security prices are more volatile than usual.

Regardless of what new path the Fed chooses, it should openly state what its policy will be so that credit markets can judge whether the Fed is making a credible attempt at long-term inflation control. Openness will allow credit market participants to hedge against unplanned outcomes. Moreover, it is important for the Fed to put an end to the policy stalemate it now faces. For in keeping the federal funds rate constant, the Fed is allowing money supply growth to fluctuate wildly, which only continues to exacerbate credit market uncertainty about the state of monetary policy.

Many analysts are desperate to find an explanation for rising inflation during a period of sluggish, if not negative, real GNP growth. As Figure 1 indicates, core inflation — the Consumer Price Index less volatile food and energy prices — headed slightly downward in the first ten months of 1989 dropping from an annual increase of 4.6 percent in January to 4.3 percent in October. During that time, real GNP growth was falling from an annual rate of growth of 3.2 percent to 1.8 percent. But from November 1989 through August 1990, core inflation jumped up to 5.5 percent while real GNP growth fell further to just 1 percent.

FIGURE 1



*PERCENT ABOVE THE CORE INFLATION INDEX TWELVE MONTHS PRIOR

No doubt, there are several Fed staff members who would argue that the slowdown in real GNP growth has been insufficient of late to hold back inflationary pressures. They would argue that the economy is still "overheating" and producing well above potential. Indeed, many analysts look at today's rising inflation and conclude that the economy must be far more robust than government reports indicate. They would, thus, continue to imply that aggregate demand must still be too high to get inflation down.

We have argued that aggregate demand is being contained by subdued growth in M2. After rising near 9 percent in 1985 and 1986, M2 growth has averaged about 5 percent in the last three years. This has brought the growth in nominal GNP down from near 8 percent to under 6 percent today. We have continually claimed that the problem of rising inflation is on the supply-side of the economy. For part of 1989, there was sufficient supply-side growth to bring inflation down. However, now real GNP growth is insufficient to hold down price increases.

The supply-side perspective of the inflation problem suggests correct policy solutions that are quite opposite to prevailing government policy. Rather than raise taxes to subdue demand, the focus should be on reducing taxes to stimulate supply. Aggregate demand can be reduced and controlled by keeping M2 growth just below nominal GNP growth. The problem is that real GNP growth must increase so that growing demand goes more toward purchasing additional products than to raising prices.

Underlying differences in policy prescriptions between demand-side and supply-side analysts is a fundamental disagreement about the power of various economic theories. Undergirding the traditional Keynesian or demand-side policy approach are the notions that the growth potential of the economy is "fixed" so that "excessive demand" will go only toward inflation, and a corollary notion that deviations from a natural rate of unemployment will drive inflation in the opposite direction — the so-called Phillips curve.

The supply-side approach to policy assumes that both the supply and demand parts of the economy are important in determining the inflation outcome. Rather than being a harbinger of excessive demand, rising real GNP growth will put a damper on inflation if modest money supply growth is put in place to contain aggregate demand growth. Rising real GNP growth will create higher income and an improved standard of living, allowing consumers to spend more. However, more available products will meet the higher spending levels without the necessity of higher prices. If supply-side incentives are created by government policy, investment would be stimulated inducing households to save more. This would sustain a new, higher rate of economic growth with increased productivity growth so that enhanced aggregate demand would be satisfied with the availability of new products and services.

Recent research published by the Federal Reserve Bank of San Francisco in its Summer 1990 "Economic Review" shows that positive or negative supply shocks in the economy tend to last longer than demand shocks. And while certain demand shocks may create the sort of Phillips curve that Fed policy makers are fond of alluding to, policy makers should endeavor to make a distinction between the type of shock involved. For example, the

authors John P. Judd and Bharat Trehan, state that:

> **A forecast of inflation for any period in the future that exceeds the inflation goal would indicate that policy should be tightened. Our results suggest that the Phillips curve model of inflation could provide misleading signals under this forecast-oriented approach to policy... To determine what a given rate of unemployment implies for future inflation, it is necessary first to determine the factors that are responsible for the prevailing unemployment rate. When analyzed in terms of the Phillips curve, supply-induced movements in the unemployment rate can lead to inappropriate policy actions.**

Judd and Trehan conclude in their article entitled, "What Does Unemployment Tell Us About Future Inflation?" that "a relatively low level of unemployment resulting from a positive supply shock, such as an innovation that improves the productivity of workers, offers little or no reason for concern about the potential for an acceleration of inflation. However, when viewed through the Phillips curve, such a change in the unemployment rate would suggest that policy should be tightened." The result is that the level of unemployment may suggest very little about future inflation and that rising unemployment, falling real GNP growth and rising inflation are compatible in the presence of long-lasting negative supply shocks.

A policy-induced rise in interest rates can be considered a negative supply shock when it entails a deliberate removal of bank reserves. Such an action directly increases the cost of borrowing and investing and lowers business profits. If two years ago the Fed misjudged growth potential and misdiagnosed the impact of a falling unemployment rate as evidence of rising inflationary pressures, then serious policy mistakes could have been made. We believe this is precisely what happened.

The story does not end here. Analysts who utilize the concept of the Phillips curve in forecasting also have in mind that the growth potential of the economy is fixed. During the 1980s while actual inflation dropped to a fairly steady rate of about 3.5 percent, the unemployment rate was falling. Steady inflation convinced these analysts to reduce their estimates of steady state unemployment rate from well over 6 percent to near 5.5 percent. However, these revisions have been less than the actual drop in the unemployment rate. And even as steady state unemployment rate estimates have fallen, estimates of growth potential, perversely, have declined as well. One would expect growth potential to increase if "noninflationary rates of unemployment" drop to lower and lower levels.

Indeed, John Boschen and Leonard Mills, in an article entitled "Monetary Policy With a New View of Potential GNP" published in the July-August 1990 Business Review of the Federal Reserve Bank of Philadelphia, argued that actual movements in real GNP growth may be due to changes in growth potential. If this view is accepted, fearful monetary policy responses over a supposed excessive rate of real GNP growth has been mistaken.

The notion of a varying potential GNP growth contends that aggregate supply changes may be highly variable. For example, labor force growth and participation as well as productivity improvements can come in bunches rather than smoothly changing over time. The reason potential GNP can change from quarter to quarter and from year to year is that in a market economy relative prices adjust rapidly so that changing demand conditions are reflected quickly in prices. Consequently, to the extent that price changes occur, full employment of resources can be maintained to the greatest degree possible even while aggregate supply and the unemployment rate fluctuates.

Maintaining full employment of resources merely means that those individuals who want to work and those who own other productive factors will alter the way they employ their resources as prices change. Positive supply shocks that lower the costs of some activities create new profit potential and attract resources away from other uses. Therefore, employment and output may rise without creating forces such as new inflation.

The demand-side approach argues that excessive growth will create new inflation with unsustainable lower rates of unemployment. This will, in turn, lead to rising unemployment later on. Therefore, fighting inflation by lowering economic growth, when growth kicks up above potential, represents little actual loss to the economy. Policymakers can conveniently ignore any pangs of conscience that come from rising unemployment rates, because the resulting slowdown is simply restoring the economy to a sustainable rate of growth.

However, the variable growth potential argument suggests that negative supply shocks inherent in policies which destroy job opportunities can reduce growth potential. Thus, declining real GNP growth and rising unemployment can be associated with rising inflation since both are the result of bad policy, not natural market forces. Rising inflation indicates that aggregate demand is growing faster than aggregate supply. Moreover, lower rates of money supply growth attendant to a policy of deliberate economic slowdown can become inflationary when supply-side shocks overwhelm the demand-side.

The authors point out that "recent evidence suggests that actual GNP movements that are due to variation in potential GNP are surprisingly large." Boschen and Mills conclude that, "If potential GNP is highly variable, policymakers should be aware that attempts to smooth changes in actual GNP growth could widen, rather than close, the gap between actual and potential output if changes in potential GNP are not recognized. Moreover, such lack of recognition would thwart the goal of price stability." Put another way, policy actions that reduce growth and growth potential can and will create new inflation.

Taken in the context of new research and analytical insights, it is dubious, at best, to base policy on the notion that potential growth in real GNP declined in the 1980s. For in the 1980s, actual real GNP growth far exceeded the assumed potential rate of 2.5 percent. In contrast to the late 1970s, the experience of the 1980s represented a reversal of falling productivity growth and labor force participation. With respect to inflation, the 1980s era of higher economic growth kept inflation down.

Inappropriate theories have led policymakers down the wrong path. Tax policy has punished investment since 1986. Discretionary, ad hoc monetary policy, since early 1998, has dragged the economy down further and a new effort to add regulations that impose new costs — supply shocks — on the economy are beginning to have serious effects. New efforts to increase taxes and add new regulations will make the recession we forecast longer and deeper.